

TaxNewsFlash

United States



No. 2022-247
August 25, 2022

U.S. Tax Court: Partnership's payments to lender were deductible interest, and not payments on an equity interest

The U.S. Tax Court today, in memorandum opinion issued in a set of consolidated cases, rejected an IRS contention that a partnership and its lender had effectively formed a joint venture that in turn was itself a partnership for federal income tax purposes, and further held that the partnership's payment of over \$1 million made to the lender was deductible as interest under section 163.

The case is: *Deitch v. Commissioner*, T.C. Memo 2022-186 (August 25, 2022). Read the [Tax Court memo opinion](#) [PDF 268 KB]

Background

A partnership in 2006 purchased a commercial rental property in Georgia by financing the property with the proceeds of a loan from a lender. The integrated loan documents included an "Additional Interest Agreement" that entitled the lender to additional interest of two types—referred to as "NCF interest" that was 50% of the net cashflow from the property and "appreciation interest" that was 50% of the appreciation in the value of the property if it was ever sold or the loan was terminated.

The partnership owned no other real property.

During the years that the partnership owned the commercial rental property, it made regular loan payments to the lender. These payments consisted of repayments of principal and stated interest at a fixed rate and 50% of the net income from the property—all of which it characterized as interest.

The partnership sold the property in 2014 and, in accordance with the loan documents, paid to the lender the appreciation interest.

On its partnership tax return for 2014, the partnership:

- Claimed a section 163(a) deduction for its payment of the appreciation interest to the partnership and reported a net loss in excess of \$1 million on the commercial rental property
- Reported net section 1231 gain of \$2.6 million

The partners reported their distributive shares of income and loss from the partnership on their individual income tax returns for 2014.

The IRS subsequently issued statutory notices of deficiency to the individual partners in the partnership, asserting that their incomes were to be increased each by an amount exceeding \$500,000 resulting from the disallowance of the appreciation interest that the partnership claimed as a deductible interest expense.

Tax Court's opinion

The Tax Court first determined that under this arrangement, the partnership and the lender were not engaged in a joint venture constituting a partnership for federal income tax purposes.

The Tax Court then held the lender did not have a “single equity interest” in its dealings with the partnership that had transformed the loan payments on genuine indebtedness to the lender into guaranteed payments made to a partner pursuant to section 707(c).

Thus, the court concluded that the appreciation interest that the partnership had paid to the lender was interest deductible under section 163—and not a payment in respect of any equity interest held by the lender.

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